Testimony of

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Before the United States Senate,

Committee on Commerce, Science and Transportation,

Subcommittee on Surface

Transportation & Merchant Marine

On Issues Relating to

the Freight Railroad Industry

May 9, 2001

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present my perspective on issues concerning the freight railroad industry relative to the industry's financial performance, current posture, and future needs. My experience spans over 35 years in the field of transportation in general and railroad economics in particular, including employment with: railroad customers (shippers), the New York Central Railroad, the U.S. Department of Transportation (DOT), several transportation consulting companies, the Interstate Commerce Commission (ICC), and the railroad industry's major trade association, where for 18 years, I was the Vice President of the Economics & Finance Department. I also have taught transportation economics and other business subjects at several universities, written a book on national transportation policy, and co-authored a book on local and regional railroads. Over the past four years, I have provided consultation to a multitude of railroad, shipper, and other organizations involved in, or affected by, freight railroads. As an independent transportation economist and consultant, the views that I present in this testimony are strictly my own, based on what I believe to be the public interest.

No matter what my past professional position, I have always believed that a financially viable, freight-railroad industry is in the public interest. After all, railroads are conduits that serve the function of providing time and place (location) utility to our nation's consumers. Adequately staffed and capitalized railroads are needed for such an important role, but at the same time, it is through the satisfaction of customer needs that railroads have the opportunity to become financially viable. Thus, the achievement of railroad financial adequacy and the satisfaction of rail customer needs are two sides of the same coin. And it is with this concept in mind, that I offer this testimony.

The current state of affairs in freight railroading is controversial, highly contentious, and somewhat beyond the comprehension of many people, but it retains the one constant that has characterized freight railroads since before World War II—a perceived financial need, commonly referenced as a capital shortfall. Railroads, in their presentations to the ICC, Surface Transportation Board (STB), and public policy makers, describe themselves as being burdened with "woefully inadequate earnings," even if individual carriers were financially stable, and no matter what the railroads earned. The industry gained support for this view from the ICC beginning in 1978, when the first annual revenue-adequacy determination was made. This determination has been continued by the STB since 1996. During more recent years, the railroads' mantra of "woefully inadequate earnings" has been replaced by "revenue inadequacy." In fact, of the four dominant railroads that currently control the overwhelming portion of railroad traffic, only the Norfolk Southern (NS) has been declared by the regulatory agency to be revenue adequate in more than a single year. The Burlington Northern (BN) was deemed to be revenue adequate in 1989 and the Union Pacific (UP) in 1995. CSX Transportation has never been found to be revenue adequate. However, what CSX's president, as well as other railroad executives,

has stated in his company's annual report to shareholders is another matter.

Incredibly, the alleged state of railroad revenue inadequacy prevailed during the early and mid-1990s, even when railroads enjoyed record earnings and the president of the industry's major trade association -- the Association of American Railroads (AAR) – touted the "Second Golden Age of Railroading." Magazine articles abounded with such positive headlines as "Back on the Right Track," and "Back at Full Throttle." Consider the financial strength at the time of the current four dominant railroads. In 1994, the BN earned an impressive 16.9% rate of return on equity (ROE) -- that is, net profit after fixed charges and incomes taxes are paid as a percent of the value of the owners' investment. Furthermore, the BN had the financial capacity to outbid the UP and acquire the Atchison Topeka & Santa Railroad (ATSF) in 1995 for $4.1 billion. Similarly, in 1995, the UP earned a 16.7% ROE and completed its purchase of the Southern Pacific Railroad (SP) in the following year for about $4.0 billion. In 1997, the CSX and NS railroads realized ROEs of 12.4% and 12.6% respectively, and consummated their joint purchase of Conrail for over $10 billion in 1999. And yet, with the exception of the NS in 1997, these railroads were declared by the STB to be revenue inadequate during those years. At the same time, the four railroads expended billions of dollars in employee buyouts, distributed expected dividends to their shareholders, and paid sizeable bonuses to their executives.

What is especially troublesome about the current state of alleged railroad revenue inadequacy is that it comes when the industry has been merged into four dominant carriers based largely on the theory that such consolidation was necessary to achieve revenue adequacy. As shown below, the number of Class I railroads has shrunk from 109 in 1960, to 36 in 1980 and to seven in 1999 -- with two of these carriers being owned by the Canadian National and Canadian Pacific railroads. Furthermore, the concentration of power has greatly increased among the four largest railroads, rising from 25% of Class I railroad traffic in 1960, to 43% in 1980, and an astonishingly 95%

Year	Number of Class I Railroads	Percent of Traffic Carried By Four Largest Railroads
1960	109	25%
1980	36	43
1999	7	95

in 1999.[1] These four dominant railroads -- two each in the East and West -- control more than the traffic they handle. They also have significant control over traffic on both local (short line) and regional railroads and either control or heavily influence: industry-wide procedures in regard to operating – including, interline -- rules; accounting practices; car-repair billing; technological research and development; and, policy development and

strategy.

What is additionally astonishing about the four "mega-railroads" is that they were created based on projections of huge financial benefits. For example, the BN's purchase of the ATSF came when the former was already making record profits, and when the BN projected that the purchase would save the railroad $450 million annually in operating expenses and add another $110 million in operating income. Similarly, the UP was earning record profits in 1996 when it purchased the SP based on an operating income benefit of $820 million by the year 2001. And the CSX and NS purchase of Conrail in 1999 came at a time when those railroads were earning moderate profits, and when they projected significant benefits mainly in the form of cost reduction and traffic diversion from motor carriage.

No matter what it is called -- that is, "woefully inadequate earnings," "revenue inadequacy," or even "sub-par financial performance," where railroads can demonstrate a capital need, they have support, if not an outright propensity, for acceptance of their industry-wide, policy positions. The answer to the question of "How can we help the poor railroads?" may come in the form of: tax relief; low-interest loans; outright grants; approval of mergers and acquisitions; rate increases to rail-dependent customers; changes in demurrage provisions; and, the warding off of otherwise desirable market competition. Consequently, with railroads still being cast as revenue inadequate by the STB, the environment exists for more of the same – that is, for more railroad behavior based on alleged capital need; more explanations for inadequate service and increased freight rates; and an even greater concentration of power. This is not to say that in some years, railroads don't have a capital need, and it is not to say that the two railroads in the East are not currently earning sub-par profits. However, the permanent state of alleged railroad financial depravity is a frightening prospect for rail-dependent shippers and should be to the public at large.

The latest rationale of the railroads' alleged revenue inadequacy is that competition forced them to pass on their massive productivity gains to their customers, proving that railroad competition is more than adequate. The productivity gains have been attributed to deregulation as enacted by the Staggers Rail Act of 1980, as is seemingly all good things that have happened to railroads since that time. In turn, the combination of continued capital need and competitive markets means that the railroads cannot afford any more competition. After all, proffer the railroads, new competitors would "skim the cream" off the top and leave the incumbents with little more than the lower-margin, more competitive traffic. This is a picture which on the surface appears to be plausible, for to refute it requires an unusually deep understanding of railroad financial data, statistical methodologies, cause-and-effect relationships, rail-customer service levels, and railroad behavior in general. In essence, railroad issues relating to national transportation policy are

often embodied in a mass of statistical information and economic theory.

My perspective of the state of the freight railroad industry is different from that being portrayed by the industry itself. As a reflection of my views, I present three observations below, including summary statements of support and recommendations, followed by a more detailed discussion leading to each of the three observations.

1. Railroad data presented in annual reports to shareholders, and supplemental data to the Securities & Exchange Commission (SEC), is often in conflict with industry-wide data distributed to and by the STB and especially that agency's annual determination of railroad revenue adequacy.

    - Railroad revenue need is synonymous with capital attractiveness.

    - Railroads compete for capital in open capital markets against companies who provide annual financial reports to their shareholders and supplemental financial information to the SEC.

    - Potential investors rely upon the financial documents prepared and provided by the owners of businesses in consideration of where and when to invest their funds.

    - Consequently, where railroad capital attractiveness is at issue, annual reports to shareholders and supplemental data to the SEC should be used as the basis for analysis.

    - At the same time, the link between the STB's annual determination of railroad revenue adequacy and capital attractiveness is at best elusive and in all probability, non-existent.

    - The annual STB revenue-adequacy determination should be terminated and railroad financial data submitted to the Board should be consistent with the information presented to shareholders and the SEC.

    - Finally, railroad revenue need should be thought of in terms of: (1) individual railroads as opposed to an industry-wide average, (2) as a fluid, and thus temporal state of being, and (3) as a prospective concept.

Railroads are no different than other for-profit companies in that they must pay their operating expenses, meet the interest obligation on their funded debt, and have the ability to attract needed equity capital if they are to provide adequate service to their customers. By earning any level of net profit, operating expenses and interest charges are paid because such profit is calculated after those payments and income taxes are subtracted from revenue. Thus, stripped of its trappings, the issue in regard to railroad financial viability is that of capital attractiveness to providers of equity. This attractiveness is enhanced by a variety of factors including the most recent returns to the providers of equity capital – measured by the ROE – a strong balance sheet, significant cash flow relative to capital expenditures, and sound management policies and procedures. Many of these considerations are discussed in the railroad's annual reports to their shareholders and other information provided to the SEC. In fact, the "President's Message" sets the tone for the annual report to shareholders. But the overall message, analysis of financial performance, and even thoughts about the future, are not revealed in the annual reports to the STB. They are also not reflected in the STB's annual revenue-adequacy determination. This disparity can lead to contradictory views by the railroad itself, and between the railroad and the STB. Consider an especially egregious case involving the UP in 1996.

By any reasonable standard, 1996 was a great year for the UP and its parent company, Union Pacific Corporation (UPC). As stated by the Chairman and Chief Executive Officer of UPC:

> *The Union Pacific merger, the spin-off of the Resources company and the full integration of the Chicago and North Western acquisition, made 1996 a banner year that created significant value for shareholders and positioned this company for the future as a highly competitive, premier transportation provider. Through all of these strategic achievements, we kept our eye on the numbers, reporting record financial results. Our income from continuing operations was $733 million compared to $619 million in 1995, a gain of 18 percent.*[2]

UPC earned an ROE of 12.4% in 1996, largely sparked by the railroad's ROE of 16.6%. To UPC and the UP, these profits were more than adequate. They not only exceeded the corporate ROE threshold that triggered executive bonuses and the long-term compensation package (stock grants and options), they also exceeded the maximum-payout level to those executives. Consequently, aside from significant amounts of stock distributions, the average bonus given to 138 UPC executives in 1996 amounted to a record $112,000.[3] Furthermore, when in 1997 UPC earnings were below the executive-bonus threshold, the corporation still awarded $7.1 million to 154 executives because "a balance was available in the reserve fund from prior years."[4] In

essence, surplus profits from 1996 were used to further reward executives in 1997. At the same time, the STB found the railroad to be revenue inadequate in 1996. Rhetorically speaking, who would potential equity investors be most likely to believe? – the company itself or the STB, which based its conclusion on a single, statistical and highly controversial calculation? The unfortunate result of the STB's declaration of revenue inadequacy is not only that it could be applied in regulatory proceedings involving maximum rates, but that the UP could adopt it as support for its positions of public policy.

In general, the financial health of individual railroads is far better than that projected by the revenue-adequacy determination. Consider the case of the four dominant railroads in 1999. While they were all declared to be revenue inadequate, the BNSF earned a healthy 13.9% ROE and the UP a moderate 9.5% ROE. While these figures may have been below the STB's cost-of-capital calculation, did they really deter either railroad from attracting needed capital? Where is the evidence of such capital shortfalls? With interest rates around seven percent, the equity investors in these two railroads were rewarded for their risk taking, and both railroads spoke of even more promising returns in the future -- that is, in their annual reports to shareholders and in their presentations to Wall Street security analysts. Furthermore, in his oral presentation to the STB regarding the BNSF's proposed merger with the Canadian National system, the president of the BNSF boasted of his railroad being into its strongest financial position in history. The reality is, that the record abounds with examples of railroad executives calling attention to their strong financial results in the annual reports to shareholders, while citing their STB-determined revenue inadequacy in matters of public policy.

In essence, the STB's annual determination of railroad revenue adequacy serves no useful purpose and can be highly misleading. A railroad cost of capital can be estimated without an annual revenue-adequacy determination. At the same time, potential equity investors can employ the more credible railroad annual reports to shareholders, and if desired, supplemental financial reports to the SEC, to help them in their determinations as to where they funds should be invested. Annual reports to shareholders represent the "real world;" the same cannot be said for the STB determination.

2. Railroad deregulation as enacted by the Staggers Rail Act of 1980 has been given far too much credit for both the significant gains in railroad productivity and the ensuing constraints on freight rates, thereby inappropriately inferring that railroad market competition is ubiquitous.

    - With the exception of liberalized procedures for eliminating light-density branch lines, there is no direct link between the Staggers Rail Act and increases in railroad productivity.

- Aside from a host of other factors, railroad productivity gains have emanated largely from favorable union contracts (supported by Presidential Emergency Boards) resulting in the elimination of many employees.

- The measure of freight-revenue-per-ton-mile is a limited surrogate for actual freight rates, and its use by the railroad industry and the STB results in improper conclusions regarding both freight rates and the impact of deregulation.

- Railroad productivity gains have been shared directly by shippers in competitive markets and the railroads themselves, but no matter how the benefits have been distributed, rail-dependent customers exist and are still faced with the lack of carrier choice.

- The existence of rail-dependent customers is a reality that should not be ignored by the STB – whose purpose is, in fact, to address the needs of such shippers -- or by national transportation policy.

- In addition to providing adequate carrier choices for rail-dependent customers, an appropriate remedy for their complaints appears to be the "Final Offer Arbitration" (FOA) process available to railroad customers in Canada.

- Professional arbitrators can replace the lengthy and costly STB maximum -rate procedures and as in Canada, complete the process within 60 days.

There is no disputing that since the Staggers Act was passed in 1980, the railroad industry has become more productive, and has passed on a portion of this productivity to some of its customers in the form of constrained pricing. But with the exception of the more liberal provisions to eliminate light-density branch lines, there is no evidence that links the Staggers Act with increased railroad productivity. The major contribution of deregulation was to free the railroads from the unnecessary cost of regulatory proceedings involving competitive traffic. Money was certainly saved in these instances, but this regulatory efficiency had nothing to do with reducing the bloated labor force, eliminating duplicate facilities, and implementing cost-saving procedures. Those achievements were due to a combination of factors including: a heightened sense of need on the part of management; the introduction of new technology, economies of scale and density associated with mergers and acquisitions, and especially, favorably-negotiated labor contracts (including billions of

dollars worth of buyouts). In fact, as shown below, the number of employees working for Class I railroads has been in a long-term decline since its peak of 2.1 million in 1916.

Year	Number of Class I Employees[5] (Thousand)
1916	2,148
1929	1,661
1955	1,015
1970	566
1980	458
1999	178

Mis-casting the Staggers Act as the cause of increased railroad productivity and constrained pricing inappropriately supports a continuation of present market conditions; and yet, this is exactly what the railroad industry and the STB do. They use an industry-wide, unaudited, inflation-adjusted, and deficient surrogate for railroad freight rates -- more specifically, freight revenue-per-ton-mile – to proffer that railroad rates have declined since 1980, and then automatically tie those alleged decreases to the enactment of the Staggers Act in that year. What is not mentioned is that the rate surrogate had been declining before 1980, and its relationship to actual freight rates is at best, dubious. Furthermore, actual rate surveys undertaken by the AAR in 1980 provide evidence as to the inappropriateness of the surrogate measure.

The reliance on the average freight-revenue-per-ton-mile measure is an example of how the manipulation of large and varied databases can act to confuse issues. The issue before the STB should not be overall, average railroad freight rates. In the first place, freight rates should be related to individual railroads, individual commodities, individual markets, levels of cost, and levels of service. But even more importantly, in regard to railroad matters, the STB exists only because there are rail-dependent customers. These customers, as well as the STB, should not be concerned with averages, surrogates, and inappropriate cause-and-affect relationships.

The reality is that deregulation did little, if anything, to address the needs of rail-dependent customers. These shippers have become increasingly vocal in regard to their captivity and the railroads' insensitivity to their needs. Similarly, they find virtually no relief in the regulatory process. While the Staggers Rail Act requires *fair and expeditious regulatory decisions*, the "fairness" of current standards is at best, questionable, and there has been nothing expeditious about regulatory decisions. Some maximum rate proceedings have taken more than 10 years to resolve, while regulatory proceedings in general are extremely costly, time consuming, and intimidating to shippers. At the same time, because

of fewer and similar operations, railroads have strengthened their common resolve and have the financial resources to employ a delay-and-wear-them-down strategy. This has added to the lengthy and costly regulatory proceedings favoring the staying power of railroads.

An alternative to the ineffective regulatory proceedings administered by the STB, would be the concept of Final Offer Arbitration (FOA), similar to the practice in Canada. In a nutshell, FOA is a process employing either a single arbitrator, or a panel of three arbitrators, to resolve rate and/or service disputes between railroads and their dependent customers. Unless otherwise agreed to by the parties, decisions are binding and last for a stated period of time. Benefits of FOA as applied in Canada, compared with current railroad regulatory practices are as follows:

- The arbitrator's decision is made within 60 days compared with proceedings taking years – in some historic cases, over 10 years.

- Railroad customers would identify their rail dependency by committing to file FOA submissions. They are unlikely to be frivolous submissions because of the accompanying costs. This eliminates the need for theoretical and controversial determinations of "captivity" and "market dominance."

- FOA offers by both parties are likely to be moderate in that the arbitrator must pick one or the other (i.e., baseball-style arbitration). An unreasonable offer is likely to be readily rejected. This brings the dispute into a more practical zone of analysis and encourages a negotiated railroad-customer agreement prior to an FOA decision.

- There are a host of available arbitrators, and thus the process has more credibility than alternative regulatory decisions. Unlike members of the regulatory authority, arbitrators are not political appointees. They are qualified experts whose records and reputations determine whether or not they will be selected for arbitration.

- The cost of arbitration is shared equally between the railroads and their customers. While the customers' initial experience in arbitration may be somewhat costly, it is far less than that of current regulatory proceedings. Furthermore, customer expenses decline as experience with FOAs is gained.

- The FOA process takes railroad-customer disputes out of the political process. Often, the disputes are resolved by the involved parties after an arbitration application is filed but before a decision is made. In essence, moving from an FOA-type decision-making process seems to be a win-win situation for railroads and their dependent customers.

3. While prudent railroad cost control is admirable, public policy can best be served if railroads increase their traffic volume, thereby helping to relieve highway congestion, having a positive impact on the environment, and providing relatively low-cost transportation service; adequate competition should help to stimulate traffic growth and improve overall profitability.

   - The major economic focus of railroads has been to maximize profits through cost reduction.

   - While intermodal traffic has grown significantly, massive railroad cost cutting has not helped railroads to increase their market share, especially vis-a-vie the motor carrier industry.

   - Traffic growth requires the satisfaction of shipper needs and in turn, this requires a sensitivity to those needs, a commitment to fulfill those needs, and innovative and flexible thinking.

   - The culture of the large freight railroads is one that is slow to change and has never been known to have keen market sensitivity.

   - Adequate railroad competition could add to railroad efficiency, but more importantly, could provide the needed sensitivity to shipper needs.

   - The encouragement of railroad competition is consistent with the goals of the Staggers Rail Act of 1980.

   - Public policy should not automatically preclude the enactment of provisions that provide for increased access – and thus, competition – to the railroad infrastructure.

   - The very same public that provided railroads with exclusive rights-of-way and limited competition has the right to adjust the level of competition when conditions demand it.

The railroads' emphasis on cost cutting over the past 20 years is well documented. In fact, projected efficiencies were the major factor supporting the many mergers and acquisitions during these years. For example, in 1980 the railroads' operating expense per ton-mile was 2.75 cents compared with 1.95 cents in 1999.[6] This decline was realized in the face of virtually a 100 percent rate of inflation during those 19 years. And as previously

shown, the reduction in railroad costs was led by draconian cuts in the level of railroad employment. Rational cost cutting is admirable and in the interest of shareholders, but what is also important -- especially to the public at large -- is that railroads recapture some of their lost market share, and here, the story is not good.

The railroads' share of intercity tonnage has steadily declined – from 46.7 percent in 1950, to 28.7 percent in 1980 and 25.1 percent in 1998.[7] During the late 1980s and early 1990s there was a leveling off of this downward trend, but it again has started to recede. In 1996 the railroad percent of market share was 25.8 percent, falling to 25.1 percent in 1997 and remaining there in 1998. With the motor carrier industry currently carrying about double the tonnage hauled by railroads, there is a substantial traffic base available for railroad penetration -- or in reality, for market recapturing. This potential traffic base is expected to expand significantly in the future, as DOT has projected annual average increases in the U.S. domestic freight market of 3.4 percent annual between now and the year 2010.[8] Furthermore, DOT projections call for an annual 4.0 percent increase in U.S. international traffic over the next decade. Clearly, there is a sizeable market for potential railroad penetration. But such penetration requires more than continued railroad cost cutting. It requires the ability to meet customer service standards at reasonable prices. It requires competition. It requires compliance with the Staggers Rail Act, which recognized the need for competition among railroads.

The Staggers Rail Act supports and encourages the existence of rail competition in the marketplace. One of its policies is, *To ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes, to meet the needs of the public and the national defense.* This policy is supported by two other policy statements: (1) *to reduce regulatory barriers to entry into and exist from the industry,* and (2) *. . . to avoid undue concentrations of market power . . .* These policies are consistent with one of the findings of the Staggers Act, which is that: *Greater reliance on the marketplace is essential in order to achieve maximum utilization of railroads to save energy and combat inflation.*

There are many ways to induce adequate railroad competition in the marketplace. Railroads themselves can generate competition through commercial agreements and voluntary sharing of infrastructure. The selling of branch lines to local and regional railroads – without so-called "paper barriers" is a form of increased competition. So are expanded reciprocal-switching zones. The STB can induce added competition by disallowing bottlenecks in its decisions on maximum rates. And Congress can mandate adequate competition through a change in legislation that provides for increased access, somewhat on the order of the "running rights" provision available to shippers in Canada. In the case of running rights, a railroad would have to petition the STB for the use of another railroad's facilities, but with over 400 local and regional railroads in existence, such a provision may

be useful. The success of such a policy is already well documented right here in the U.S. and by the railroads themselves. Both BN and UP have testified that the application of 4000 miles of trackage rights—which were imposed by the STB as a condition of the UP-SP merger—are working very well for both customers and railroads. And despite claims to the contrary, when railroads oppose policies that would increase access in this way, trackage rights have resulted in no safety or operational problems, at least none reported by the railroads at this time. The point is, that adequate competition is not evil. In fact, competition is the only route for ensuring long-term financial viability for the rail industry. Deregulation and competition are inseparable. With adequate competition, the partial deregulation that now prevails can be completed and full deregulation can be implemented. Partial deregulation with ineffective regulation is not a formula for traffic growth. Without meeting shipper needs, the future of a privately-owned-and-operated, financially viable, freight railroad structure in this country is dubious. Meeting customer needs is the number one priority of virtually all for-profit companies in competitive markets, and it must be at the core of national transportation policy affecting railroads. Adequate competition is what drives customer satisfaction, and this basic concept of the free-enterprise system is what drives the country's standard of living.

In conclusion, it is my belief that staying the present course – that is, preventing adequate competition while relying on ineffective regulation – will do little, if anything, to ease the burden on rail-dependent customers, to make railroads more customer-driven, and to grow the traffic. At worse, it will lead to further consolidation and possibly, to government subsidization of the freight-railroad infrastructure.

I thank you for the opportunity to prevent my views, and I would be pleased to answer any questions.

ENDNOTES

1. Association of American Railroads, Analysis of Class I Railroads (annual). Interstate Commerce Commission, Statistics of Railways in the United States For the Year 1960.

2. Union Pacific Corporation, 1996 Annual Report, "Letter to Our Shareholders," p. 1.

3. Union Pacific Corporation, Proxy Statement to the Securities & Exchange Commission, 1996, from DGAR database on SEC's Web Site.

4. Ibid, 1997., p. 21.

5. Association of American Railroads, Railroad Facts and Railroad Ten-Year Trends. Interstate Commerce Commission, Railroad Transportation, A Statistical Record, 1911-1951, and Statistics of Railways in the United States For The Year Ended 1929, 1955, 1970.

6. Analysis of Class I Railroads, Ibid.

7. Eno Transportation Foundation, Transportation in America 1999, p. 46.

8. Federal Highway Administration, U. S. Department of Transportation, Freight Forecast Growth Rates, 2001.